STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois Commerce Commission On Its Own Motion	)	
	)	
vs.	)	Docket 01-0707
	)	
The Peoples Gas Light and Coke Company	)	
	)	
Reconciliation of revenues collected under gas adjustment charges with actual costs prudently included.	)	

CITY EXHIBITS 2.0 – 2.1

REBUTTAL TESTIMONY OF JOHN H. HERBERT

ON BEHALF OF

THE

CITY OF CHICAGO

PUBLIC VERSION

Submitted February 18, 2005

REBUTTAL TESTIMONY OF JOHN H. HERBERT

Introduction And Summary Of Testimony

Q. Please state your name, business address, and occupation.

A. My name is John H. Herbert. My business address is 2929 Rosemary Lane, Falls Church, Virginia 22042. I am an independent consultant, and I have been retained by the City of Chicago (City) in this matter.

Q. Have you previously provided testimony in this proceeding?

A. Yes. My Direct Testimony was submitted in this docket in August 2003.

Q. What is the purpose of your Rebuttal Testimony?

A. Like my Direct Testimony, this Rebuttal Testimony discusses issues raised by the failure of The Peoples Gas Light and Coke Company (Peoples Gas or the Company) to protect its regulated bundled service customers against gas price risk exposure during the period leading up to and during its Fiscal Year 2001 (FY 2001), the reconciliation period for this proceeding. My Rebuttal Testimony responds specifically to the rebuttal testimony filed on behalf of Peoples Gas by Frank Graves, David Wear, Thomas Zack, and Valerie Grace. I also address comments on hedging in the Additional Direct Testimony filed by David Rearden on behalf of the Illinois Commerce Commission Staff (Staff).

Q. Please summarize your discussion of the principal issues you respond to in your Rebuttal Testimony and your conclusions respecting those issues.

A. The witnesses I respond to presented commentary on various aspects of my evaluation of the Company's gas supply management practices and my estimation of the economic harm suffered by customers as the result of imprudent actions by the Company. The Company's main criticisms are presented in the testimony of Mr. Graves. His position is that Peoples Gas was not imprudent for failing to take measures to protect captive customers against gas price risk because, he says, the Illinois Commerce Commission (the Commission) has never encouraged or required utilities to use hedging instruments. Graves Rebuttal at 6, L.131-134; pages 17-18, L.506-509. My review of Peoples Gas' actions (as opposed to its arguments) shows that Peoples Gas has previously undertaken hedging activities without the pre-approval or encouragement that the Company now insists are prerequisites. I also discuss Peoples Gas' apparent strategy of merging the distinct issues of determining prudence and the separate, follow-on determination of any resulting economic harm. Only by artificially conflating the two issues can Peoples Gas complain of supposed hindsight review. I also emphasize that the benefits to regulated customers from the Company hedging can be enormous at times. Mr. Graves emphasizes that the costs and benefits of hedging balance or cancel over time, suggesting that there is little to be gained from hedging. In the final major area discussed, I revisit a fundamental question of this proceeding: whether Peoples Gas attempted to reduce the price risk exposure of its regulated customers by following a prudent price risk management plan for them during the reconciliation period.

The Staff presents brief comments on price risk management by Mr. Rearden, who merely expresses his distaste for hedging, without providing any objective supporting evidence. By the tests Mr. Rearden applies to my proposed hedging disallowance – that correction of an imprudent decision or action "necessarily" provide lower prices and that the utility commit affirmative imprudent acts (as opposed to neglecting or deciding not to act prudently) – even the Staff's proposed disallowances could be rejected. For example, a valid element of Staff's criticism of the GPAA is that Peoples neglected or refused to solicit bids for the contract, yet that action that would not "necessarily" produce lower prices.

My Rebuttal Testimony on these issues reaches the following conclusions.

- Peoples Gas' obligation to act prudently in providing regulated services to its customers does not depend on pre-approval or micro-management directives from the Commission. It is the Company's job to manage utility operations as the law requires, not the Commission's.
- Peoples Gas' actions and words before this case reveal that the Company has not previously considered hedging activities either imprudent or unauthorized, even in the absence of specific approval of such activities by the Commission.

- My assessment of Peoples Gas' supply and price risk management decisions and actions was based on contemporaneous circumstances and information. The distinct quantification of the harm resulting from decisions and actions already determined to be imprudent necessarily uses additional information (actual market prices, for example) to compare what would have happened without the identified imprudence.
- Peoples Gas' complaint that I engaged in a hindsight review rests on the Company's improper melding of the two unrelated issues.
- Based on my review of the Company's price risk management activities, the focus of Peoples Gas' plans ultimately appears to be more on profit for the Company than on protection for its ratepayers. And, it is clear that Peoples Gas did not have a prudent price risk management plan for the benefit of its regulated customers in place for the reconciliation period.
- Staff's expression of an opinion respecting hedging is nothing more than that, since it does not even attempt to consider the relevant contemporaneous facts.

Q. How is your Rebuttal Testimony organized?

A. Before responding to the specific claims made by the various Peoples Gas witnesses, I present a brief overview of the pertinent recent history of hedging by Peoples Gas and other Illinois utilities. This overview shows that Peoples Gas and other Illinois utilities have treated hedging in the same manner they treat other utility operations questions, as a utility responsibility that is subject to review by regulators. Then I respond to the testimony of individual witnesses. Where more than one person testifies on a topic, I reference other witnesses in my response to the principal witness on the common issue.

Peoples Gas Hedging Overview

Q. You mentioned earlier Peoples Gas' hedging activities in the period before and during the reconciliation period. Can you provide details of Peoples Gas' policies and actions respecting price risk management?

A. Yes. A review of those activities is easily accomplished by focusing primarily on three documents. These documents show Peoples Gas' knowledge of important aspects of effective hedging, and about the need and purposes for a hedging program to address the highly volatile natural gas prices. These three documents – two from the Company, and one Commission document – also provide a timeline of the changes in Peoples Gas' positions and actions with respect to hedging. The documents I refer to are:

- Peoples Gas' 1998 **"Gas Supply Price Protection Financial Trading Strategy"** (1998 Price Protection Strategy);
- Peoples Gas' **"Gas Supply Protection Strategy,"** a document **dated March 12, 1999**, that was produced as part of the electronic discovery in this case (filepath: rodrr/homedirs/rodrr/1999/RiskMgmt/Protection Strategy2.doc); and
- the **Manager's Report in Commission Docket 01-NOI-1**, which was presented to the Commission in November 2001.

Q. What does the first document show?

A. The first document is Peoples Gas' 1998 Price Protection Strategy, which the Company adopted in August 1998. According to Mr. Zack (at p. 13-14, L. 280-285), this also was the hedging plan that Peoples Gas had in place during the reconciliation period. Peoples Gas' 1998 Price Protection Strategy is primarily notable for two reasons. First, the document confirms that Peoples Gas engaged in hedging activity, without the Commission encouragement or pre-approval that the Company now insists must be present before a utility can prudently hedge – and without the adverse consequences that supposedly make hedging risky for utilities. Second, the planned implementation of the strategy appeared to be focused more on benefits to the Company than to the consumer. The strategy was not focused on reducing the price risk of regulated customers.

Q. As to your first point, what details does the document provide about Peoples' past hedging activity?

A. The document states that the Company had "**[CONFIDENTIAL MATERIAL REDACTED X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X]**" When asked specifically about the details and context of its "existing programs," Peoples Gas gave an account of its practices (in response to City DR 1.088, attached hereto as City Ex. 2.1) that undercuts the core of Mr. Graves' arguments. Peoples Gas confirmed that before it implemented its hedging program, the "Commission did not require or encourage [the Company] to use financial hedging instruments." Peoples Gas added that it "did not seek [Commission] approval" for the hedging activity described, and that it did not believe prior Commission approval was necessary. Peoples Gas' actions and its explanation for those actions are inconsistent with Mr. Graves' advice about preconditions for utility implementation of financial hedging programs. Finally, Peoples Gas' response confirms that, consistent with the utility's expectations, the Commission permitted recovery of its hedging costs. In fact, Peoples Gas admitted that it is not aware of <u>any</u> instance in which the Commission has denied recovery of hedging costs permitted by Commission regulations.

Q. With respect to the second point you made, please explain your statement that the 1998 Price Protection Strategy did not provide any price risk management benefits to captive customers.

A. The 1998 strategy delineated a price trigger to hedge when gas prices dropped to a certain level. The 1998 Price Protection Strategy was focused on the price level instead of price risk, which is the upward and downward movement around any price level.

Q. What is the second document that describes Peoples Gas' relevant hedging experience?

A. The second document was produced as part of the electronic discovery that Peoples Gas turned over to the City, other intervenors, and Commission Staff after discovery was re-opened in February 2004. That document is entitled "Gas Supply Protection Strategy" and is dated March 12, 1999. The document's filepath is rodrr/homedirs/rodrr/1999/RiskMgmt/Protection Strategy2.doc.

Q. Why is this document important?

A. Unlike its August 1998 predecessor, the 1999 strategy was "designed to mitigate price volatility ***for our customers*** during the summer and winter months therefore providing the ratepayers with stable and reasonable prices over time." (Emphasis added). In other words, the document outlines a hedging strategy generally consistent with the requirements I defined in my Direct Testimony for a prudent hedging strategy. But, even though a strategy to protect customers was prepared and at hand, according to Mr. Zack, the strategy was never implemented. (The documentary evidence is unclear on whether it was even approved within the Company.)

Also, the document cites studies by two analysts predicting that gas prices would be increasing in the 2000s. A Solomon Smith Barney study referenced in the strategy attributes the expectation of increasing prices to declining production. According to the Peoples Gas' document, Solomon Smith Barney predicted that **"[CONFIDENTIAL MATERIAL REDACTED X X X X X X X X X X X X X X X X X X]"** This forecast is further evidence that, as I stated in my Direct Testimony, it was known going into the injection season of 2000 and the heating season of 2000-2001 that prices were very uncertain due in part to a tight supply situation. (*See*, *e.g.*, Herbert Direct at 30, L.747-

749.) More important, this document makes it clear that Peoples Gas was aware of these market conditions.

Finally, the document describes the appropriate quantity of gas to be hedged as **"[CONFIDENTIAL MATERIAL REDACTED X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X]"** (Emphasis in original). This approach, except for the summer base load purchase requirements, is consistent with the approach I recommend in my Direct Testimony as a component of a prudent hedging program. (*See e.g.*, Herbert Direct at 30, L.1216-1300) And, the volume that the document identifies as eligible for hedging – 65 BCF per year – is similar to the 64 BCF that I suggested that Peoples Gas should have hedged during the reconciliation period. Mr. Graves' testimony is again called into question, since he criticizes my use of this approach to estimate customer harm as "sized and timed" "hindsight" analysis. (Graves Direct at 6, L.152-154.)

Q. What is the third document that speaks to Peoples Gas' recent hedging experience?

A. The third document is the Manager's Report in Docket 01-NOI-1. That case was an inquiry ordered by the Commission regarding the dramatic increases in gas prices during the 2000-2001 winter. The Manager's Report, which documented the results of the Commission-ordered investigation, was presented to the Commission in April 2001. As part of that proceeding, the Commission Staff reviewed the hedging activity of Illinois' gas utilities. The results are presented in a section of the Manager's Report on "hedging and risk management." The Report's discussion of hedging is interesting for several reasons. First, the Report states that the Commission Staff has not sought prudence disallowances for hedging costs, even when "hedges ended up with ratepayers absorbing ***significant*** financial losses…." Report at 44-45 (emphasis added). Second, the Report expresses the Commission's policy on hedging costs: "neither the Staff nor the Commission is opposed to hedging or liable to second guess legitimate risk management activities when hedged gas costs turn out to be higher than subsequent spot market prices." Manager's Report at 43. Not surprisingly, that statement of policy is consistent with the requirements of the Commission's PGA regulations, which were in effect during the reconciliation period.

Mr. Graves' advises in testimony that utilities should not hedge without prior Commission approval because they may subject themselves to after-the-fact disallowances if customer prices increase. The Manager's Report, and Peoples Gas' admissions that it did not view pre-approval as a prerequisite and that it is unaware of a single instance in which hedging costs have been disallowed, undercut Mr. Graves' position.

Rebuttal to Testimony of F. Graves

Q. At page 4, L.95-96 of his Rebuttal Testimony, Mr. Graves asserts that you offered evidence of hedging by certain of Peoples Gas' affiliates to show "that prudently-

operated businesses hedge commodity price risk." Was that your purpose in noting the contemporaneous hedging activity of Peoples Gas' affiliates?

A. Actually, that comparison of behavior was offered to show that in the circumstances known to market buyers and sellers in FY 2001, Peoples Gas' affiliates, which Peoples Gas does not assert are unreasonable business actors, did see a need to hedge when looking at the available market information. Mr. Graves also challenges my use of unregulated business behavior on hedging as a benchmark for assessing the reasonableness of Peoples Gas' actions and decisions. For reasons I discuss elsewhere in this testimony, I disagree with his contention that such comparisons are inappropriate. However, even if the Commission finds his view worth some consideration, there are regulated companies in Illinois that acted to hedge price risks in the FY 2001 market environment. The Ameren companies hedged two-thirds of winter supply. NOI Manager's Report at 42, fn. 20. Utilities operating under the same regulatory regime as Peoples and in similar market circumstances used fixed-price contracts and financial instruments -- in addition to physical storage, which Peoples Gas claims was able to serve as its price hedge, to reduce customers' exposure to price risk.

Q. Mr. Graves asserts (page 6, L.128-134) that the hedging disallowances proposed by you and by CUB witness Brian Ross are inappropriate because you both ignore past Commission decisions, which, he says, have never provided guidelines regarding the use of hedging instruments. Is this a valid criticism?

A. No. Mr. Graves and I clearly disagree on the meaning and effect of the ICC's regulations and decisions on procurement practices under the PGA. Mr. Graves apparently reads the

Commission's refusal to require or to encourage hedging to meet prudence obligations means that hedging can never be required for prudence, regardless of the circumstances. I do not.

A large portion of Mr. Graves' rebuttal testimony is devoted to the claim that Peoples Gas should be excused from having to hedge a portion of their gas supplies for the 2000-01 winter because the Commission, in past orders, has not specifically "required" or "encouraged" such protection against price volatility for customers. (*See*, *e.g.*, Graves Rebuttal at 13, L.344-45, page 15, L.427-28, page 16, L.451-52.)   Most of that testimony comprises his interpretations of orders from the Commission and other utility regulators.

His argument is essentially this: Peoples Gas (and other utilities) should not use financial hedges to protect against price risk unless there is clear direction or encouragement from their regulator, because they run a risk of cost disallowances. In other words, Mr. Graves argues that utilities are absolved from the obligation to act prudently to protect customers from price risks – or perhaps any other obligation – unless a particular action has been specifically ordered or encouraged by the Commission to eliminate the risk of cost disallowances.

This argument is a radical departure from traditional precepts of utility regulation. First, the utility obligation to act prudently is rarely, if ever, set aside, since it is a policy *quid* *pro quo* for the utility's grant of monopoly. Second, utilities routinely face the threat of disallowances if their decisions or actions (in this or any other area) are found to have been imprudent. It is remarkable that Peoples Gas is suggesting that its obligation with respect to gas purchases should be set aside because the Commission did not step into the Company's shoes and make its business decisions for it.

This is the crux of Mr. Grave's error. The portion of a Commission document that Mr. Graves reproduces, but does not pay much attention to, states in plain words the reasons why the Commission has expressly declined either to require or to encourage specific hedging measures, which Graves posits are prerequisites for an imprudence finding. That explanation does not support Mr. Graves' position.

> ***It is no more wise to create rules for hedging than it is to create rules for . . .*** the degree to which the company can rely upon firm transportation versus interruptible transportation services in swing months, . . . or ***any number of other details related to the prudent management of a utility's business. The Commission sets rates*** to prevent monopolies from taking advantage of market power, ***the Commission does not manage utility companies."*** Graves Rebuttal at 14-15, L.405-416 (citing NOI Manager's Report in Dkt. 01-NOI-1 (Apr 17, 2001) (emphasis added).

What Mr. Graves asks that Commission provide are absolute, detailed directives that are independent of particular factual circumstances -- and that a utility can use with no risk of a disallowance. That approach is the antithesis of a ***utility's*** traditional ***obligation to manage its business prudently***, without the burden or the crutch of regulatory micromanagement.

Q. Are there other reasons you believe Mr. Graves' reading of the Commission's decisions is wrong?

A. There are several indications that the Commission's decisions are not the bar to prudent hedging activity that Mr. Graves maintains. And, he has identified nothing in Commission policy that excuses a utility from its duty to act prudently. The manner in which the Commission has applied its PGA regulations, including utilities' cost recovery under those regulations, does not support Mr. Graves' argument.

As I mentioned in my Direct Testimony (at page 43, L.1096-99), the Commission modified its purchased gas adjustment clause (PGA) regulations to add specific language that allows recovery of hedging costs.[1] Since that time, Illinois utilities, including Peoples Gas and its affiliate North Shore Gas, have designed price risk management programs that include the use of such financial instruments as futures and options contracts without a Commission order approving or directing hedging, or releasing the utility from possible disallowances. In fact, Peoples Gas acknowledges using financial hedges without the Commission approval and direction it now insists are prerequisites. (*See*, City Ex. 2.1.) The Company's 1998 Price Protection Strategy describes its new hedging program as "more comprehensive than ***existing programs*** in which Peoples and

[1] Peoples witness Mr. Wear testified in the Company's FY 2000 last reconciliation case (Docket 00-0720) that the Company is aware that the Dkt. 94-0403 modifications to the PGA regulations permits the recovery of hedging costs through the PGA. (Docket 00-0720, tr. at 53.)

North Shore works [sic] with its suppliers to ***temper price volatility on 10% to 20% of winter baseload purchases through the suppliers' use of financial instruments.***" (Peoples' Response to Staff Data Request ENG 2.031 (emphasis added).)

Q. Was Peoples the only utility to take hedging actions?

A. No. According to the Manager's Report in ICC Dkt. 01- NOI-1, there were other utilities in Illinois that had active hedging programs during the reconciliation period (and in the prior reconciliation year). These programs were undertaken without a Commission directive or encouragement from the Commission. And, there were no Commission-ordered disallowances associated with these programs.

Q. Your description of Peoples' activities suggests that specific Commission approval was not as essential, in the estimation of Peoples Gas, as Mr. Graves insists. Did Peoples Gas act consistently with Mr. Graves' argument that it would be imprudent for the Company to hedge its gas purchases and risk disallowances?

A. The City asked Peoples Gas in discovery (DR 1.088) whether the Company had, in fact, acted as Mr. Graves insists any prudent utility would act – that is, hedge only at the Commission's direction or encouragement because of the risk of disallowances. Peoples Gas responded:

> Existing programs in which Respondent would secure pricing based on a supplier's use of financial instruments were a part of supply negotiations and not part of an approved strategy or plan.
>
> Respondent ***did not seek approval*** of programs under which suppliers, but not Respondent, used financial instruments to

> support the supply prices for gas sold to Respondent. The Commission ***did not require or encourage*** Respondent to use financial hedging instruments. Respondent ***does not believe*** the pricing program required Commission approval, and, therefore, it did not seek approval. Respondent ***did not believe that it was imprudent*** to have such a program because, ***while the Commission did not encourage these types of programs, the results of any program would be subject to review*** as part of the annual gas charge reconciliation process and ***Respondent is unaware of any disallowance related to such purchases***. Significantly, the program did not involve the purchase of financial instruments by Respondent; instead, suppliers used financial instruments, as they deemed appropriate, to support their price offer to Respondent. (Peoples' Response to City Data Request 1.088 (emphasis added), attached hereto as City Ex. 2.1.)

Peoples Gas admits that it proceeded without Commission directives or encouragement. As to Mr. Graves' assertion that it would be imprudent for a utility to hedge and risk disallowances, Peoples Gas admits that it is not aware "of any disallowance related to such purchases" by suppliers. Although Peoples Gas tries to distance itself from the hedging activity by emphasizing the role of its suppliers, the description of the program approved by Peoples' Gas Trading Risk Management Committee requires that **"[CONFIDENTIAL MATERIAL REDACTED X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X]"** (Peoples Gas' Response to Staff Data Request ENG 2.031 (emphasis added).) For prudent price risk management using financial instruments Peoples Gas could either purchase the financial instruments directly or – as it did in its earlier programs – rely on its suppliers. Peoples Gas also has acknowledged that its Gas

Purchase and Agency Agreement with Enron North America ("ENA") could facilitate hedging activity. (Herbert Direct at 41, L1037-44, citing, Peoples Gas' Response to CUB DR 6.001.)

Q. It appears that Mr. Graves is saying that you contend that Peoples Gas should have "hedged in a fashion similar to [your] recommendations" to be prudent? (Page 6, L.148-149.) Do you take that position?

A. I do not read his testimony as saying that exactly, although the sentence you refer to is ambiguous. His testimony refers to "Mr. Herbert's claims that the circumstances . . . were sufficiently self-evident that Peoples should have hedged or that it should have hedged in a fashion similar to his recommendations." I do testify that the circumstances during the relevant time period were sufficiently evident that Peoples Gas was imprudent in ignoring them and refusing to hedge its gas purchases. I do not take the position that Peoples Gas had to hedge using a program like the one I used for calculating the harm to ratepayers. In fact, it is Peoples Gas' failure to take any reasonable hedging action in the circumstances that is the basis for finding that the utility was imprudent. The specific hedging program I described was for the sole purpose of estimating the resulting harm to Peoples Gas' customers, not to suggest that it or any other specific hedging program was Peoples Gas' only prudent course of action. Mixing the two issues as Mr. Graves does can only tend to confuse, not assist, the Commission in evaluating the testimony in this case.

Q. At page 6, L152-153, Mr. Graves states that you used "hindsight information in advancing [your] disallowance[] proposal" and that the difference between your and Mr. Ross' disallowance estimates demonstrates arbitrariness in the prudence determination. How do you respond?

A. Mr. Graves (L152, L886, L921), confuses or intentionally conflates the determination of the utility's imprudence with the separate issue of estimating the harm from imprudence suffered by ratepayers. The difference in the estimates of harm from Mr. Ross and me says nothing about Peoples' imprudence.

My Direct Testimony purposely kept the two questions separate, and it was organized to avoid precisely the confusion Mr. Graves attempts to inject. My examination of Peoples Gas' gas supply practices was conducted on the basis of information known to Peoples Gas or readily knowable to industry observers at the time of the utility's decisions and actions for the reconciliation period. Both Mr. Ross and I conclude that the utility was imprudent in its lack of reasonable price risk management. The difference in ratepayer harm estimated by Mr. Ross, in comparison to my estimate, relates only to distinct approaches in gauging the harm customers suffered from that (already determined) imprudence. The damages calculations themselves are necessarily retrospective, since they attempt to recreate the past with different decisions taken. Since no one can redo the past, any such estimation necessarily makes some assumptions. I used an objective, prudent hedging strategy and actual data from the period, to estimate the harmful effect on customers. The estimate looks backward only to retrieve Company information, such as the actual PGA prices paid, and market prices available for use in a hedging program designed as part of prudent supply practices.

Q. Why is Mr. Ross's estimate of damages different from yours?

A. Mr. Ross's estimate of damages is different from mine because we developed our estimates within different frameworks and, to the extent judgment was required, we proceed from distinct bases of professional experience.

My volume estimate to compute the damages is based more on the operational aspects of Peoples' supply obligations. I assume that minimal purchase requirements based on the weather realities the Company faces (warmest heating season monthly requirements) are reasonable volumes for a utility such as Peoples Gas to hedge for a number of reasons as indicated in my direct testimony at pages 36-37, L.906-935. In developing his volume estimate, Mr. Ross did not focus explicitly on factors such as weather, the particular service requirements of the Company, or the Company's specific capabilities. My volume estimate began with the range of service environments in which the Company operates, that is the weather associated with coldest, normal and warmest heating season months. Other factors, such as operational flexibility, and knowledge of (and actual experience with) using financial hedging instruments, support the use of larger volumes, as discussed in my direct testimony and in this rebuttal testimony.

Q. Mr. Graves also asserts (page 6, L.153-154) that your "disallowance proposal" is "sized and timed to fit the events of this particular gas cost reconciliation." How do you respond?

A. It is difficult to respond when it is not clear what I am being accused of doing. If Mr. Graves is saying that the ***program*** on which my disallowance proposal is based was "sized and timed to fit the events," his accusation is baseless, and it is false. As I explained at some length in my Direct Testimony, I chose a hedging program that is general, is expected to achieve specific outcomes, and guards against price speculation influencing the hedging decision. If he is saying that my ***estimate*** of ratepayer harm is "sized and timed to fit the events of this particular gas cost reconciliation," he is correct. An estimate of harm for some other set of circumstances would not be relevant to this proceeding.

I also note that Mr. Graves does not propose any alternative method of calculating the harm to customers and does not offer any alternative quantification of harm if the Commission finds that there was imprudence. Similarly, he suggests that hedging in the summer months might also have been indicated by the available information in FY 2001, but provides the Commission with no estimate of the effect of such a hedging program.

Q. Mr. Graves testifies that absent indirect costs to a firm or its customers from certain types of harms that he labels "costs of financial distress," "there is no real reason to hedge." (Graves Rebuttal at 11, L.277, 280-281.) Does this suggest to you that there was no reason for Peoples Gas to hedge gas price risk?

A. Not at all. The "costs of financial distress" described in Graves' testimony – impaired credit, lack of funds for other needs, and dealing with a highly unstable financial environment -- are precisely the "indirect" costs or harms suffered by Peoples Gas' customers because the utility did not "alter the extremes that realized costs could possibly reach" (Graves Rebuttal at 10, L.272) by hedging its purchases. Peoples Gas' awareness of the potential harm to customers of severe price variability is shown in its budget payments plans for customers. One indicator of the financial distress customers faced in the reconciliation period is the increase in Peoples Gas' uncollectible bills in the following year, 2002. Uncollectible bills jumped from $17 million and $18 million dollars in fiscal years 2000 and 2001, respectively, to $54 million in fiscal year 2002. Given Peoples Gas' sensitivity to uncollectibles, the utility was likely well aware of the clear correlation between high bills and high uncollectibles. An effective hedging program could reduce the size and number of unpaid or late-paid bills for the Company by moderating the economic impact of such customer bills.

Q. Mr. Graves states that hedging is not about reducing or minimizing cost. Do you agree?

A. I agree that hedging is not about minimizing the cost of the commodity over time. But, hedging for regulated customers is very much about reducing costs at times of price extremes and reducing customer bills at times when price risk exposure is greatest.

Hedging for regulated customers is about reducing bills in a cold heating season, when both the volume of gas required and the price of the commodity are likely to be very high. (Recall the skew towards high natural gas prices, a fact on which both Mr. Graves and I are in agreement.) Since both price and volumes are likely to be greatest in cold weather, customer bills (price*quantity) will increase as a proportion of regulated customers' available income. This is especially true for those customers who can least afford to pay, those on fixed and limited incomes. During a cold heating season monthly bills of $300.00 are not unheard of in Chicago. For a family with an annual income of about $15,000, a $300 gas bill is about 25% of the available monthly money income. In a normal weather heating season the same customer bill might be $200.00, or about 15% of available monthly income. Hedging programs focused on regulated customers are about keeping gas bill spikes in check, reducing the conflict with bills for medicine, food and other necessary expenditures. In addition, from Peoples Gas' perspective, hedging should also reduce additional administrative and interest costs associated with late paid and unpaid bills.

Q. Mr. Graves suggests that the standard of reasonable business behavior is different for regulated businesses. Do you agree?

A. The Commission's standard of prudent behavior for regulated utilities is based on the expected actions of a reasonable business person in similar circumstances, given the information that was known (or that should have been known). Mr. Graves' suggestion would completely nullify the regulatory objective of anchoring the standard of prudence for regulated enterprises operating as monopolies in the reasonable decision-making behavior of ordinary businesses, which operate in competitive environments. Mr. Graves' reasoning would leave regulators without any comparative except other regulated entities, which may have the same lack of incentive associated with cost pass-throughs to captive monopoly customers. Regulators do not take Mr. Graves' approach with benchmarking comparisons for rate of return purposes, for example, and the Commission should not do so here.

Q. At pages 21 and 24, L.606-607 and L.697-699, Mr. Graves states that Peoples Gas shareholders do face the risk of disallowed costs from hedging because, in hindsight, regulators could determine that a different approach would have produced better prices. Do you agree?

A. Mr. Graves' observation about the risk of hindsight determinations by regulators is valid only if one assumes that the Commission can be expected to violate its own regulations and any applicable laws by refusing to adhere to the prudence definition it has established. A determination of possible imprudence of Peoples Gas' decisions and actions should not be distorted by a presumption that the Commission would act in such a manner.

Q. At page 24, L.714-719 of his Rebuttal, Mr. Graves suggests that because price volatility was not significantly greater in the period immediately preceding Peoples Gas' 2000 injection season than it had been in a previous period, it was not

reasonable to expect Peoples Gas to begin hedging its heating season 2000/2001 requirements. Do you agree?

A. No, I do not agree. Mr. Graves' discussion tries to turn the issue into a simplistic numbers game. He suggests that if price volatility is estimated to be numerically higher or lower than in an earlier period, a company reasonably will be more or less inclined to hedge.

A utility company hedges because natural gas price volatility is high, not because it is higher or lower than it was last year. Gas prices are known to be more volatile than other commodities. Even Mr. Grave concedes this. City Exhibit 1.3 shows, in an accessible way and using a simple measure of price volatility based on the previous exhibit of price changes (City Exhibit 1.2), that gas price volatility varies greatly and can be extraordinarily high -- but never approaches zero. A utility company also hedges because its volume volatility (or customer requirements) can vary greatly throughout the year. Yet, Mr. Graves tends to ignore volume volatility in his testimony.

Using this simplistic numbers game, Mr. Graves even implies that a focus on volatility means Peoples Gas should have hedged summer requirements because computed price volatility was high. That rhetorical suggestion is wrong, and it has no basis in my testimony. As my Direct Testimony explains, hedging manages price risk exposure and exposure is focused on customer requirements, or volumes. Price risk exposure is least in summer. Demand is lower and relatively stable, and prices are most often lower. Only by ignoring the volume factor can Mr. Graves suggest a "strictly volatility" strategy for managing price risk exposure for customers. Since price risk exposure is related to customer bills, which are determined as price times volume, by ignoring the volume component, Mr. Graves once more does not fully address customers' price risk exposure.

For sound hedging decisions, the combination of overall patterns, levels and extremes of price and volume volatility are of most interest. "Cherry-picked" time periods, like the January to March span Mr. Graves selected to support the point he wanted to make about price volatility, creates a biased sample and cannot support sound decision-making. Similarly, any valid "statistical test," where standard conditions need to be satisfied, cannot rest on a biased sample. In my previous testimony, I reported numbers for the season (heating or non-heating) generally relevant for utility decision-making. For example, I used data for the non-heating season where the issue was injections into storage and other preparations for Peoples Gas' November to March heating season. This is the reason I reported summary volatility numbers for the non-heating period and compared them with the preceding year's data. The comparison showed that the volatility numbers were large and were not declining significantly.

Mr. Graves seems to interpret my choice of the non-heating sample period as testimony that hedging positions must begin in April. As I just explained and will explain further below, it is not. Mr. Graves' reading of my analysis also ignores all practical considerations, which usually have a significant bearing on when hedging and injection activity begins. But, relying on volatility numbers for January to March of 2000 and the previous year (1999), Mr. Graves appeared to be looking for an additional incentive for Peoples Gas not to hedge – despite the fact that overall price risk was known to be large. He reports volatility levels of 48% (for 1999) and 39% (for 2000) for his "statistical test." Volatility for the longer November 1999 to March 2000 period, which was the most recent heating season and a natural period for senior management to consider and inquire about in planning meetings to discuss price risk management for the upcoming heating season, was 54% (from the data reported in my Direct Testimony). None of these volatility numbers are small enough to be ignored by prudent management, and none of them suggest natural gas commodity price risk is modest.

Q. In your proposed hedging program, you used the months of April to October as the months over which a Company would put on hedges. Does this mean that hedging positions necessarily start in April as Mr. Graves suggests in his testimony (page 24, L.721)?

A. No, not at all. I recommend hedging at random intervals over the months of April through October because April through October is when injections and plans for the upcoming heating season usually are made. It is the most natural period to consider. It is also a way of making the hedging automatic so that hedging decisions are not determined by speculations about price. However, hedging may begin in any month prior to the heating season. On the other hand, information about the behavior of price volatility during the injection season may motivate senior management to make the decisions to initiate the hedging program. Senior management is often juggling a variety of responsibilities and may need to be reminded of the need to focus on the hedging program and make the necessary decisions so that the price risk manager may begin the program. For this reason, volatility estimates or other related data (such as the range for price on a day) should be regularly tracked, and summaries and displays of a variety of measures of price risk should be provided to senior management by the manager of the price risk program.

Q. Mr. Graves also suggests on page 30, L.895-902 of his testimony states that only hedging for winter (i.e. heating season) purchases is arbitrary. Do you think this position is useful advice for a price risk manager?

A. Clearly not. A risk manager at a natural gas distribution company such as Peoples Gas should be focused first of all on the heating season. The heating season is when volumes purchased and hence bills increase significantly. The heating season is also where the chance of price spikes is greatest and when price volatility usually increases. If price volatility is examined going back to 1995, it is clear that price volatility exhibits a seasonal behavior, as do volumes required by regulated customers. Both price volatility and customer requirements tend to increase in the heating season. The heating season is also the period when many distribution companies historically have used storage as a physical hedge, for good reason. In contrast, I know of no natural gas utility that uses its storage as a hedge for requirements of its regulated customers during the summer.

Nonetheless, if summer purchases were to be hedged as Mr Graves seems to suggest, then the summer purchases and the corresponding hedged volumes would need to be clearly allocated to regulated customers requirements during the summer. If the summer purchases that were hedged were instead placed into storage for eventual distribution to residential customers during the heating season, then these stored volumes at fixed prices would need to designated as regulated customer supplies. This latter practice is at odds with Peoples Gas' stated policy for stored volumes. (Interestingly enough, according to the Company, the only exception to this Company policy is where the stored volumes are part of a parking service – *i.e.*, when the Company has an opportunity to make a profit.)

Q. In a discussion that begins at page 26, L.756 of his rebuttal, Mr. Graves suggests through a review of statistical data that the magnitude of the price spike in the 2000-2001 winter made it so unexpected, unpredictable, and extreme that Peoples Gas could not have known it was coming. Does this explain or excuse Peoples Gas' failure to hedge?

A. No, not at all. In fact, this very unpredictability of price is the reason companies should hedge. Hedging is not speculating about future price levels. Hedging to obtain lower prices is an approach that even Mr. Graves acknowledges (in other circumstances) (Graves Rebuttal at 12, L.323-327) is inappropriate. Yet, here he suggests that the enormity of the price level change from past levels excuses the Company's failure to hedge prudently – irrespective of the high level of observed price volatility.

Moreover, even if we assume, for discussion purposes, that deviations from an average price level were an appropriate trigger for hedging decisions, Mr. Graves' own average price analysis would have provided Peoples more than enough information to warrant putting more resources into price risk management. Refer to Exhibit FCG-2, and focus on the price information near the beginning of 2000. (I assume that the Company would consider its witness' average data representative.) One can see that the daily prices were systematically above his average. For an average to be a useful statistic, the price quotes must sometimes be above and sometimes below the average. Mr. Graves' exhibit shows that the price quotes were systematically above the average, making that average a poor guide for making decisions or evaluating management performance, either then or now. A similar deficiency is revealed in price quotes above his 1 standard deviation level, which then continued above that level. The decision-makers in the Company were faced with an average that was clearly shifting upwards. Mr. Graves' Exhibit FCG-3 shows the same thing; the forward price curve was generally moving upwards throughout the year for successive forward curves, and, sometimes (May-June, for example), the shift upwards was particularly large.

One would think that a company as focused on price levels as Peoples Gas, which it says "understood its task going into fiscal year 2001 to be minimizing gas costs, not volatility" (Zack Rebuttal at 12, L.244-245), would support a greater emphasis on price risk management for regulated customers upon seeing these data.

Q. Were there other factors that would have signaled the need for a hedging strategy even to a company looking mainly at price levels?

A. Yes, as I explained in my Direct Testimony, the distributions of price and price changes are skewed towards high values. This means that the chance of extremely high prices and price changes is greater than the chance of extreme low prices. Peoples Gas does not dispute this fact about gas prices. (In response to CTY 1.102, Mr. Graves admitted that the "distribution is skewed, as is typically the case for gas.") Mr. Graves' graph illustrates that if the expected price for a commodity is about $20.00, the chance of getting values $20.00 above this expected value is much greater than the chance of getting values $20.00 below this expected value. In fact, the chance of getting values less than $5.00 (only $15.00 below the expected value) approaches zero. This readily available knowledge about the skewed distribution of gas prices should have prompted caution in emphasizing averages of historical or forecast prices for hedging decisions.

Q. On pages 11-12, L.303-307 of his testimony, Mr. Graves states that "Mr. Herbert seems to have confused his valid observation of the fact that gas prices are skewed with the incorrect inference that this means the upside total cost risk exceeds the downside. Forwards must be priced to balance the expected upside against the

downside, even if these two outcomes will be experienced in very different ways." Please comment on his assessment.

A. The fact that prices are skewed to the high side indicates that in a particular heating season the chance of extremely high prices and high damages exceed the chance of extremely low prices. Perhaps a brief explanation of what this means to consumers would be useful.

Assume the Company has hedging positions in place and is faced with a high average market price (average price above the hedged price). The difference between the high experienced average price and the hedged price is called the price gain. When we multiply this price gain by the volume hedged, the dollar amount computed is the amount of savings to regulated customers from hedging – or, in Mr. Graves more abstract words, upside total cost risk.

If the Company is hedged and faces a low average market price (average price below the hedged price), we call the difference between the hedged price and the experienced low price the price loss. When we multiply the price loss by the volume hedged, the dollar amount computed is the cost to regulated customers from hedging – or, in Mr. Graves more abstract words, downside total cost risk. Over time, it is expected that the upside total cost risk and the downside total cost risk will be balanced, that is they will cancel each other out. But for particular heating seasons, because the price distribution is skewed toward high prices, the number and value of large gains is expected to exceed the number and value of large losses.

Q. On page 29, L.863-873, Mr. Graves states that a natural gas utility must assess its customers comfort with price risk and that this is the proper way to choose among the many plausible arrangements, such as providing some customers with market variable prices and others with fixed prices Do you agree?

A. It might be useful to have such information, but it would be very difficult to obtain, since such questions are difficult to survey. But, consistent with their responsibility to run the business, most utilities make the decision to support price risk management in the same way that they make many other business decisions. They make judgments based on the available information and reasonable business prudence. For example, some customers would like more frequent meter readings, and others would be comfortable with less and save money accordingly. Yet, companies do not conduct studies to discover this. I do not know of a company that asks its customers about their preference as to the timing and allocation of its storage withdrawals, even though these decisions may affect both their reliability of service and their exposure to price risk.

Q. Mr. Graves makes the claim on page 22, L. 657-659 of his rebuttal testimony that Peoples Gas used its storage like a hedge for its regulated customers' winter (heating season) requirements. Do you agree with this claim?

A. Not at all. In fact Mr. Graves, in response to CTY 103, acknowledges that he was not at all familiar with the relative use of LIFO accounting and FIFO accounting by gas utilities in the United States. More important, he does not appear to be familiar with the fact that Peoples Gas does not allocate a portion of its storage to regulated customers. It is difficult to understand how Mr. Graves can make the claim that the Company may use its storage as a physical hedge if he does not consider the relevant features of the Company's storage practices. He does not address features such as the accounting system used to cost stored gas, the allocation of stored gas withdrawals with a known cost to regulated customers, and the specific LIFO accounting method the Company uses.

Q. On page 29, L.859-860 of his testimony, Mr. Graves concludes that because the volumes for which you and Mr. Ross recommend hedging are different you are "speculating about what would or should and could have been done." Do you agree with this conclusion?

A. Absolutely not. I used data provided by the Company, and there was no speculation involved. My recommendation to match hedged volumes with the expected minimum requirements of regulated customers follows directly from the discussion in my Direct Testimony and is supported by my professional experience. The recommendation is also consistent with testimony and workshops I have presented to a variety of industry stakeholders and in an article published in a major utility industry journal. The volume I recommended is the amount that can be hedged effectively, as described in my testimony. This approach also is similar to the hedging program used to illustrate utility hedging in a recent comprehensive GAO report on price risk and price risk management (General Accounting Office, Analysis of Changes in Natural Gas Prices, GAO-03-46, 2003). This report was coordinated with the Federal Energy Regulatory Commission and the Commodity Futures Trading Commission – regulatory commissions charged with oversight responsibilities, not unlike the Illinois Commerce Commission.

I note, in addition, that Mr. Graves again conflates the issue of Peoples Gas' imprudence ("what could and should have been done") with the estimation of harm from actions or decision found to be imprudent (recommended hedged volumes).

Q. Have you learned anything that might explain Peoples Gas' failure to implement prudent price hedging practices during the FY01 reconciliation period?

A. The testimonies of the Staff witnesses and City/CUB witness Lindy Decker suggest a possible explanation. As I detailed in this testimony and in my direct testimony (pages 24-28, L.596- 716), Peoples Gas was well informed about such instruments as futures, options, and fixed price forward contracts used to manage the price risk in its commodity purchases. Nonetheless, the utility decided not to initiate any price risk management actions considered in connection with its fixed rate supply proposal or its 1998 and 1999 price protection plans.

One explanation may be that a prudent hedging program during the reconciliation period could have blunted the profit opportunities that were meant to be captured by the unusual transactions and arrangements between Peoples Gas and subsidiaries of Enron and

Peoples Energy. Those arrangements and their apparent objectives were discussed in the testimonies of Ms. Decker and Staff witnesses Andersen, Rearden, and Hathhorn. The enovate activity also could have kept price risk management support for regulated customers out of focus. That is, it may have diverted the attention of Peoples Gas managers from protecting customers against avoidable exposure to gas price risks to completing hub transactions. This lack of focus existed prior to 2000, and decisions made prior to and during the reconciliation period likely worked to the benefit of the involved non-utility entities and to the disadvantage of regulated customers. Whether as a result of inattention or a deliberate decision, Peoples Gas did not implement a prudent hedging program.

Rebuttal to Testimony of D. Wear

Q. Beginning at page 58, L.1302 of his Rebuttal Testimony, Mr. Wear criticizes the hedging volumes used in your estimation of the economic harm to Peoples Gas' customers as "unrealistic" because of certain system operation factors. Can you respond to those criticisms of the volumes you used in your calculations?

A. Mr. Wear makes two observations, and he argues that they mean the volumes I estimated the Company could have hedged are unrealistic. First, he says – without any further explanation -- that I ignored all storage activity in my analysis. He asserts that this factor alone would have "reduced Mr. Herbert's numbers." I will assume that he means the hedging volume numbers, though he does not clarify his remark or explain how that factor would reduce hedging volumes. If Mr. Wear is referring to Peoples Gas' claimed use of storage as a price hedge, his testimony is inaccurate. The goal of hedging is to fix, in advance, the price of natural gas for regulated customers' expected heating season requirements. Peoples Gas did not fix the price of any identified volume of gas for regulated customers prior to delivery during the heating season. If Peoples Gas had designated some portion of its gas in storage for delivery to regulated service customers at a set price, the stored gas would have provided a hedge for the customers. The Company has confirmed that it does not operate its storage in that manner, even though the integrity of an effective hedge program rests on adequate records of the hedging transactions. Peoples Gas does not designate a portion of its stored gas for regulated customers and does not fix or determine the price of the gas until it is withdrawn. The price of withdrawal quantities was constantly changing during the heating season, because the LIFO pricing mechanism Peoples Gas uses for stored gas is partly a function of expected future prices and volumes – not just past costs and volumes. Moreover (as I explained in my Direct Testimony), Peoples Gas' actual use of storage during the reconciliation period apparently did not provide any hedging benefit for its regulated customers. Peoples Gas has not directly challenged my calculation showing that its customers paid approximately $10 million more during the 2000-2001 winter than they would have had Peoples Gas had simply purchased all of their needs on the spot market. Herbert Direct at 46, L.1156-1177. (Witnesses presenting Additional Direct Testimony in this proceeding have suggested reasons why Peoples Gas' considerable storage capacity was not used to or failed to provide meaningful protection for customers during that period.)

Second, Mr. Wear asserts that my use of hedged volumes requires identical daily purchases that are not operationally feasible. In fact, operational constraints on what Peoples Gas can do relate to the prudence of what Peoples Gas actually did. The operational aspects of the hedging program used to estimate the harm to Peoples Gas' customers is a distinct issue. In any case, Peoples Gas' system actually supports considerable operational flexibility. The Company should be able to inject into storage excess gas supply (over demand) from a steady low-level flow of gas associated with warm heating season requirements and required by a hedging protocol. If Peoples Gas has the capability to support significant park and loan services because of its operational flexibility, it should have the ability to use storage assets to support a prudent hedging program. However, this capability is reduced when park and loan activity is increased. An operational inability to handle the Company's norm of warmest monthly heating season requirements (the hedging volume I recommend) would itself constitute imprudence.

Q. Mr. Wear (page 58, L.1296-1298) and Mr. Zack (page 12, L.231-239) criticize your reference to the Company's $140 million saving estimate, stating (a) that the estimate related to 2003, rather than 2002 as indicated in your testimony, (b) that a change in regulatory climate make a comparison irrelevant, and (c) that the figure is not comparable to your recommended disallowance. Is the amount of Peoples Gas' claimed savings from its hedging activity after the reconciliation period meaningful in the context of this proceeding?

A. Yes, it is. First, although the $140 million figure was for the year 2003, it provides an indication of the potential savings from hedging activity even when the weather is not as cold as in November and December 2000 and market circumstances are not as extreme.

Q. Mr. Wear (page 58, L.1298) offers a $130 million figure to challenge your testimony that during the reconciliation period end use customers were not advantaged by the way Peoples Gas used its storage facilities. Please comment on Mr. Wear's analysis.

A. The magnitude of the claimed hedging benefits possible from Peoples Gas' storage tends to validate the magnitude of my recommendation. However, Mr. Wear's calculation is not what he claims, and it does not demonstrate a benefit for consumers from how the Company used its storage assets during the reconciliation period.

Given Peoples Gas' assertion that this is a measure of the benefits to consumers, Mr. Wear chose a very utility-focused approach that does not capture actual effects on ratepayers. It is instead a strictly volume-based difference in calculated costs for injections and withdrawals. In other words, it is simply the estimated net cost to Peoples Gas of withdrawal and injection volume differences over the 12-month reconciliation period -- assuming the same unit cost for all purchases and all withdrawals in each month. That calculation completely ignores the effects of Peoples Gas' LIFO pricing, which determines the amounts customers have to pay.

Peoples' LIFO pricing methodology does not charge end users the Company's monthly average costs. Instead customers pay an amount based on LIFO accounting, but modified using both actual historical purchase costs and estimated future market prices. Also, under Peoples' LIFO pricing methodology, all injections and withdrawals from storage (whether for regulated or unregulated services) affect the price paid by regulated customers, not just withdrawals or injections for a separate regulated customer account. (In fact, Peoples insists that its operation of storage facilities is independent of such ownership distinctions, which it deems impossible.) (*See*, Peoples Response to CTY 1.011.)

However, it is able to use ownership distinctions in its parking services using storage. Hedging using storage could be viewed as parking, where the PGA natural gas purchases are parked in storage at a known price until it is withdrawn from storage for regulated customers' heating season requirements.

Q. Can you illustrate these points with a simple example?

A. Of course. What Mr. Wear's calculation says is this. Assume that all withdrawal volumes (W) in a given month -- for both hub service and PGA customers -- were priced to customers at Peoples Gas' weighted average unit cost of purchases ($P/Dth) in that month. (Ratepayers actually pay a LIFO-based price). Assume further that all injection volumes (I) in the same month cost Peoples Gas the same $P/Dth. Then the net market based cost effect of the withdrawal/injection volume imbalances ($P/Dth times (W – I) Dth) is supposed to represent a customer benefit from use of its storage.

For example, assume withdrawals of 10 Dth in a month when purchase costs averaged 4 cents per unit. Assume further that injections in that same month totaled 6 Dth. Peoples Gas' calculation would characterize the difference between the withdrawal and injection volumes for that month multiplied by the Company's unit cost for purchases of gas in that month -- (10 Dth – 6 Dth) x 4 cents/Dth = 16 cents – as customer savings. Mr. Wear incorrectly presents this result as a customer benefit from the Company's use of its storage capacity.

Rebuttal to Testimony of V. Grace

Q. Does Ms. Grace also comment on the claimed price hedging benefits of Peoples Gas' storage facilities?

A. Yes, she does. But, she never responds to the main point I made in my Direct Testimony. At pages 3-4 L.54-57 of her Rebuttal, after noting my skepticism about Peoples Gas' claimed use of its storage assets as a price hedge, Ms. Grace instead addresses a different question that avoids, rather than confronts, the points I raised. Ms. Grace discusses the ***hypothetical*** benefit of summer/winter price differentials under LIFO accounting. (Mr. Wear does the same thing in his rebuttal testimony (page 58, L.1294-1296).) The exhibits Ms. Grace presents also fail to refute the criticisms that the customer prices determined using Peoples Gas' LIFO-type pricing does not fix or cap any prices for a fixed volume of natural gas that is assigned to regulated customer accounts during the injection season for withdrawal from storage for these customers during the heating season.

In my earlier evaluation of the prudence of Peoples Gas' procurement practices, I noted that storage ***could*** be used as a hedge against price risks. However, I concluded that Peoples Gas' storage does not appear to have been used for that purpose in the reconciliation period. My testimony pointed out that in FY 2001, Peoples Gas' customers paid more for gas than they would have if Peoples had simply bought gas on the spot market as it was needed. (Herbert Direct at 46, L.1134-1177.)

Rebuttal to Testimony of T. Zack

Q. In his Rebuttal testimony (page 4-5, L.77-85), Mr. Zack identifies three policy issues that he believes the Commission should consider, suggesting that the characteristics he describes apply to the disallowances you have proposed in this case. The first issue he lists is "consistency in regulation." Can you comment on that issue?

A. The legal aspects of the Commission's authority in this area are matters I will leave to the lawyers. But, I would like to comment on the policy issues Mr. Zack raises. Mr. Zack interprets "consistency in regulation" to mean consistency in result, without regard to the particular facts of a specific case, which may differ from the facts in other cases. According to Mr. Zack's logic, a regulatory commission could not decide a case on the testimony presented to it in a specific proceeding because it would be obliged to reach the same result reached in prior Company cases and in other utilities' cases. Consistency in the application of the Commission's policy on prudence does not dictate an identical result in every case. The Commission's prudence standard is based on reasonableness, and reasonable business people do not make the same decision in all fact situations.

Q. Mr. Zack next cautions the Commission against proposed disallowances based on "hindsight review and mere difference of opinion" (page 5, L.82-83). Do these criticisms apply to your proposal?

A. No. There was no "hindsight review" in my evaluation of the prudence of Peoples Gas' decisions and practices. Mr. Zack focuses this particular criticism on the Staff's proposed GPAA disallowance, because apparently Staff did not uncover every flaw in the GPAA the first time they reviewed it.

Separately, Mr. Zack concludes that certain findings of imprudence are actually mere differences of opinion, because the estimates of harm are small relative to his chosen benchmark, total gas costs. According to Mr. Zack, because the economic effect of an imprudent action was small, any negative assessment of the action can only be a mere difference of opinion -- not imprudence. Mr. Zack confuses imprudence with the effects of that imprudence. Ironically, at the same time, he criticizes my proposed disallowance (and Mr. Ross' proposal) as "punitive" because they are <u>not</u> small in comparison to the ***same*** operations figure.

Q. What do you say in response to Mr. Zack's assertion that your proposed disallowance is "punitive" (page 5, L.83-85)?

A. Mr. Zack testifies that my proposed disallowance is unreasonable when compared to Peoples Gas' net income. Mr. Zack ignores the fact that the harm to the utility's customers was not limited by the Company's level of profits. The disallowance I proposed is a measure of the excess charges customers paid because of Peoples Gas' imprudence, not some calculation of loss or gain to Peoples Gas. The relevant measure of an appropriate disallowance is the amount of excess costs recovered through PGA charges to customers as a result of the Company's imprudence, not Peoples Gas' net income.[2]

Q. Finally, Mr. Zack criticizes disallowance proposals related to the Company's hub activities because they were not made or considered in a previous case (page 6, L.108-111). Do you have a comment on that testimony?

A. I discussed this issue earlier in connection with Mr. Graves' testimony. Briefly, both Mr. Zack and Mr. Graves seem to be looking for absolute, before-the-fact rules that apply regardless of the relevant circumstances. According to their testimonies: if hub activities were ever approved once, then even expanded or changed activities must be also be permissible, regardless of any change in circumstances. Similarly, by his logic, if the

[2] At pages 11-12, L.231-239, Mr. Zack criticizes my comparison to the Company's $140M hedging savings estimate because of the fiscal year used. He and Mr. Wear offer an estimate of $130M in savings from hedging for the reconciliation period. The conclusion is the same. Prudent hedging would have significantly reduced gas costs.

GPAA was approved once, later decisions on how it is implemented are immune from examination, and if hedging was not required for prudence before, hedging can never be required for prudence, even if the relevant circumstances have changed. Such a policy (ignoring new information or changed circumstances) would make regulatory oversight virtually meaningless.

Q. In your direct testimony, you stated that you could not determine whether Peoples Gas actually had a price risk management plan in operation in FY 2001. Has Peoples Gas presented additional evidence in the rebuttal testimony of its witnesses that demonstrates that the Company had a prudent price risk management plan in place for the FY 2001 reconciliation period?

A. The additional information provided in the Peoples Gas' rebuttal testimony does not establish either the existence or the particulars of a ***prudent*** price risk management plan for the benefit of PGA customers during FY 2001.

Q. Mr. Zack seems to portray the Company's 1998 Price Protection Strategy as a hedging plan for customers that had to be "measured" because of the Commission's "lack of encouragement" for certain strategies. Do you agree with that characterization?

A. That testimony (pages 13-14, L.266-285) is interesting for several reasons. First, while Mr. Zack says that the Company's focus is on minimization of gas costs, like Mr. Wear (Wear Rebuttal at 39, L.865-866), Mr. Zack acknowledges the relevance of price volatility in prudent price risk management (page 13, L.266-267). Second, Peoples admits that the only price risk management program it had in place during the reconciliation period was one that the Company (not a consultant – pages 13-14, L.281-285) adopted in August 1998.

The planned implementation of the strategy appeared to be focused more on benefits to the Company rather than to the consumer. The strategy was not focused on reducing the price risk of regulated customers. (Although Mr. Zack discusses what he sees as the Company's incentives to manage gas prices, he never denies that the PGA shielded the utility from direct economic pressure to manage gas price risk exposure for its captive customers.)

Q. Does the 1998 Price Protection Strategy possess the components of a prudent price risk management program for a major utility that you describe in your Direct Testimony (L.881-1005)?

A. No. The type of price management program I advocate in my Direct Testimony is designed to manage price risk exposure for the utility's customers. Peoples Gas' 1998

Price Protection Strategy did not have that objective. To the contrary, a review of the 1998 Price Protection Strategy document reveals that the Company in the implementation of the strategy was focused more on increasing profit opportunities for itself.[3]

Moreover, the document appears to have been developed as part of the Company's proposal to eliminate its PGA and to collect gas costs through base rates in Commission Docket 98-0820. After rejecting the Commission's modifications to the Comapny's proposal in Docket 98-0820, Peoples Gas did not change its 1998 Price Protection Strategy to reflect this new reality, or its obligation to follow prudent procurement practices. Instead, that plan – with hedging guidelines that expired in March 1999 -- was not replaced until April 19, 2001. That is, from March 1999 through April 19, 2001, Peoples Gas may have had a plan nominally in place, but that plan was clearly not focused on the price risk exposure of regulated customers.

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[3] Statements in the August 1998 Price Protection Strategy confirm this objective. The plan states (at two separate places) that locking in prices at a certain level represents a **"[CONFIDENTIAL MATERIAL REDACTED]"** Moreover, the document further states that "**[CONFIDENTIAL MATERIAL REDACTED] X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X X "** (Emphasis added.)

Q. Was the August 1998 Price Protection Strategy in place during the 2000-01 winter?

A. We have Mr. Zack's after the fact statement to that effect. Even so, we have not been able to confirm from the documentary evidence that Peoples Gas actually followed any clear risk management program in FY 2001.

The August 1998 Price Protection Strategy may have been in place simply by default. However, because the August 1998 plan does not establish hedging guidelines for any period beyond March 1999, the 1998 program could not have functioned as a prudent price management strategy during the reconciliation period.[4]

Q. So, what was the status of Peoples Gas' price risk hedging programs during the reconciliation period?

A. I cannot, with certainty, describe the particulars of what (if any) hedging strategy was actually being followed for the reconciliation period. But, from the available evidence, it is clearer than ever that Peoples Gas has not demonstrated that it had in place, and implemented, a prudent price risk management plan for FY 2001. Peoples Gas has not

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[4] The August 1998 Price Protection Strategy states that its hedging volumes and target prices were designed to lock in **"[CONFIDENTIAL MATERIAL REDACTED]"** But, there is nothing in the August 1998 Price Protection Strategy establishing hedging guidelines for any period other than **[CONFIDENTIAL MATERIAL REDACTED]**. Nonetheless, according to Peoples' response to discovery, the Company did not adopt another Price Protection Strategy until April 19, 2001 – after the 2000-01 heating season.

claimed or described such a price risk management plan, with functional hedging guidelines, for FY 2001. Peoples Gas has not claimed or presented, and I have not found, documentary evidence that the Company ever replaced its 1998 plan with one focused clearly on regulated customer protection.

Q. Does this conclude your Rebuttal Testimony?

A. Yes.